BORROWING FROM YOUR BANK

STUART H. PATTERSON

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By

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PREFACE

There is need for closer co-operation and better understanding of banks on the part of business men. Banks must lend money to produce revenue with which to pay operating costs and return a profit on capital invested; but it must be done at minimum risk and always with the proviso that the bank shall be in liquid condition in the event that its depositors wish to withdraw their money. This is a matter which business men should always bear in mind in applying to banks for loans.

The purpose of this book is to indicate what banks require from borrowers in the way of information, security, and reciprocal relations, so that prospective borrowers may prepare themselves in advance, and consequently, receive a more cordial reception from the officers of a bank's loan department. Some of the many different ways in which banks can be useful to their customers are pointed out and the fact is emphasized that a bank's success depends largely upon the success of its customers; that, therefore, customers should draw freely on their bank for financial advice and information, and since advice based on partial information is worthless, should be unreservedly open and above board with their bank.

Every effort has been made to present the fundamental requirements for close relationship between the business man and his bank in simple language, free from technicalities, and to discuss the principles as being equally applicable to all customers, whether the corner grocery store or the largest corporation.

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BORROWING FROM YOUR BANK

CHAPTER I

RECIPROCAL RELATIONS BETWEEN BANK AND CUSTOMER

Activities Restricted for Lack of Capital.—A business man should not restrict his activities for lack of capital if he sees opportunity to enlarge them profitably. Business expansion is of two kinds: first, that which is permanent, requiring the investment of permanent capital; and second, that which is temporary and for which the necessary temporary capital may be in the form of a loan which it would be justifiable for a bank to make. Permanent expansion—it is obvious—requires the greater thought and consideration because a business executive should be very sure that the expansion *will* be permanent and that his business can carry the burden of additional capital during poor years. Otherwise he would do well to hesitate a long time before he adds to his overhead charges.

On the other hand, if the temporary operation has merit, does not require the locking up of funds beyond a reasonable period, and if the situation is properly presented, the money can usually be borrowed from a bank. Many loans are refused because of lack of frankness on the part of the would-be borrower, or through the borrower's failure to have at hand pertinent information regarding both his general business and the specific matter under discussion. Bank officials are continually ap-

proached by plausible gentlemen desiring to make loans for one purpose or another, but having no intention of repaying them at maturity, if at all; consequently, bank officials must be continually on guard to select the good loans from the bad ones. And one purpose of this book is to point out the principal information desired by banks from prospective borrowers, and to outline the methods by which banks review such data, so as to assist those desiring credit for legitimate business purposes to make proper presentation of their case.

What a Bank Considers in Lending.—In making a loan a bank must look first to the safety of the loan—whether it will be paid promptly at maturity; whether the collateral (if it is a secured loan) will have a ready market in case of default at maturity; or (if it is an unsecured loan) whether the borrower can pay one hundred cents on the dollar in the event of a forced liquidation.

A bank must next consider whether, in view of the maturities of its other loans and the probable withdrawal of deposits at certain seasons of the year, it is justified in lending the money for the period desired by the borrower. It must also determine whether if it advances the full loan desired, it may have to refuse loans to other depositors who may desire accommodation during the period involved. Into this latter phase of the problem enter the prospective borrower's relations with the bank; that is, whether he has been carrying a good deposit account, or has brought much business into the bank, for there is and must be a mutual relationship between the bank and its customers. A bank cannot exist without customers, and

business men would find it almost impossible to transact business without banks. It is only natural that banks should give first consideration to their best customers, although these may not necessarily be the people handling the largest transactions.

Similarity of Banks and Trust Companies.—Before entering into a discussion of bank loans it may be well to review the reciprocal relations between banks and their customers. A bank is an institution chartered by the National Government or a state. In its simplest function it accepts the deposit of money from individuals, firms, and corporations, subject to their check, and then lends out the funds during the period in which they are not required by its depositors.

A trust company performs substantially all the functions of a bank, except that it does not have the right to issue money in the form of bank notes. The general adoption in recent years of the word "trusts" as descriptive of large business combinations, has created confusion in the minds of many people as to what a trust company really is.

Trust companies were originally organized to transact various kinds of trust and fiduciary business, such as acting as executor and trustee for personal estates, as trustee under corporate mortgages, etc.; but they have gradually entered into general banking business. Conversely, banks are now permitted to transact trust business, so that today there is practically no difference between the business transacted by a bank and that performed by a trust company. For the sake of simplicity both types of or-

ganizations will be referred to as "banks" in the following pages.

A Bank's Services Used by All Depositors.— A bank's most common service to depositors is the collection of checks, drafts, coupons, etc., for them. (The many other services it can render them will be referred to later.) It is doubtful if many depositors ever realize the vast machinery that has been created to make possible the smooth and speedy collection of these items, or the amount of expense necessary to maintain the machinery. Suppose there were no banks and that a man in one town sold a bill of goods to a man in another town; how would he receive his pay? Probably he would be obliged to go in person, or else send a messenger to collect his bill in currency, and possibly also, he would run the risk of being robbed during the journey. This primitive method of collection would not only be dangerous but would be expensive as well, while the bank, through its correspondents, accomplishes this work with safety, economy, and dispatch. If a depositor gives any thought at all to the matter when making a deposit it is probably merely one of satisfaction that he has a check to deposit.

The other most universal common service a bank renders is the payment of checks drawn by depositors as they expend their money. To render this service it is necessary for the bank to keep records showing at all times how much balance each depositor has in his account.

These operations appear simple, but they necessitate the employment of officers and clerks, and involve various expenses which the bank must earn by loaning out the

deposits in its possession. If a bank allows interest on deposits, this also must be earned.

Therefore, a bank affords depositors a cheap and safe way of transacting their financial affairs, and as compensation has the use of part of the money while it is on deposit, because a portion of the money must be held under the law as a reserve to facilitate the payment of deposits in the event of heavy unexpected withdrawals.

Obligations of Depositors to Bank.—The average depositor probably does not give much thought to his obligations to his bank unless he is borrowing money. But there is another side in this matter of obligations. As previously stated, it costs money to run a bank. The necessary earnings the bank must make out of the funds deposited with it, and if a depositor's balance is small, the bank has little or no chance to make sufficient money to pay the salaries of the clerks who make the entries in his account, particularly if his account is at all active. Consequently, a depositor should keep a sufficient balance to permit the bank to make at least a little profit over the cost of operation, and if the account is active, that is, if many checks are drawn and numerous items are deposited for collection, a correspondingly larger balance should be maintained.

The reader may say, "I would gladly do it if I had the money, but I haven't it, so I cannot keep a good account." This condition is recognized by banks, and many of them are willing to take small accounts to start with, in the expectation that the depositors will prosper and that ultimately the accounts will be profitable ones. This

should be realized and remembered by such a depositor when prosperity comes to him. Small depositors can also frequently make a return for the service rendered by a bank even before that time by recommending people to the bank, or by influencing business in its direction.

In many cases banks make monthly service charges for carrying accounts of depositors with small balances, in order to cover part of the loss incident to the expense occasioned by having the account, and such depositors cannot reasonably object to moderate charges for this service which permits them the privilege of having a bank account.

Reconciling Deposit Accounts.—Some banks supply depositors with monthly or quarterly statements of their accounts, and some operate on the "pass book" system.

The statement system is doubtless the better, unless the depositor is careful to send his pass book in to the bank to be balanced once a month, because the statements are sent out at regular and frequent intervals, thus affording opportunity to discover quickly any irregularities in the account.

It is very important for a depositor to reconcile (or balance) his account with the bank at frequent intervals, to protect both the depositor and the bank against irregularities.

With many banks which have the statement system, it is customary to send statements to all depositors at the same time, in order to prevent irregular items being hidden in one account for a time and then transferred to

some other account. If a depositor will co-operate with his bank by promptly reconciling his account and returning the acknowledgment to the bank, anything of this kind will be disclosed immediately. A depositor can always secure a reconcilement with his bank, but a bank can only obtain a reconcilement through the co-operation of the depositor. If a depositor fails to co-operate in this respect after the bank has repeatedly sent him statements with request for reconcilement, and if irregularities subsequently develop in the account which would have been discovered and stopped if the reconcilement had been made promptly, it is possible that the courts would find negligence on the part of the depositor and not hold the bank liable beyond a reasonable period after the receipt of the first irregular statement by the depositor.

Depositors should co-operate to give protection to their banks by promptly reconciling their accounts; there are also conditions under which it may mean a loss of money to a depositor if he does not do it.

Advantage of Time Deposits.—The legal reserve required on time deposits is less than on demand deposits, and consequently banks are able to allow higher rates of interest on time funds.

There are two common methods of handling time deposits. One is by the use of a certificate of deposit payable on a certain date which is issued by the bank and which it delivers to a depositor. The other method is by an agreement in which the depositor agrees to give the bank 31 days' notice before withdrawing his funds. Therefore, if an individual or corporation has more funds

on deposit than it has immediate need for, arrangements can be made to hold a specified portion on 31 days' notice, and the depositor will thereby receive more interest during that period.

This arrangement for time deposits is of particular advantage to the depositor, because of the higher rate of interest; and it is also helpful to the bank, as it facilitates its operations in loaning out money and fixing the maturity dates of loans.

CHAPTER II

BORROWING MONEY OF BANK

Bank's Problem.—Another principal function of a bank is the loaning of money, and while this may appear to be a simple matter it is really a business transaction that is surrounded by endless complications.

In the first place, the bank must always have money available when depositors wish to draw it out, and one safeguard imposed by the law in this respect is that the bank must carry a certain percentage of its deposits in a reserve account. Members of the Federal Reserve System must carry their reserve accounts with a Federal Reserve Bank, and the banks derive no income from this reserve.

The reserve is, however, only a partial measure, and in addition, the bank must keep its other funds liquid in case depositors wish to withdraw beyond the amount carried in reserve. A bank's first duty is to its depositors, and it must be able to meet any call, at any time; i.e., it must keep its resources liquid.

One means of keeping a bank in liquid condition is by confining the greater portion of its loans to notes eligible for rediscount with the Federal Reserve Bank, a process which will later be discussed at greater length.

Another means is to arrange its loans so that the maturities come due at evenly distributed dates throughout the year. This results in a certain amount of ready

money coming in daily. Another method is to arrange that the maturities shall come at the periods of the year when withdrawals by depositors are heaviest.

To keep this machinery working smoothly, a bank must know that loans will be paid at maturity. Of course, in many instances, loans are renewed, but this is in effect a new arrangement, which the bank may decline to enter into if it has made other commitments of its funds. Therefore, a borrower should always be prepared to pay his loan at maturity.

Some one has said that the quickest way to make a winter pass, is to give a 90-day note in December. This may or may not be true, but certainly a person should not borrow money if he does not know how he is going to pay the loan when it is due.

Lines of Credit.—In order that a bank may be able to apportion its loaning funds out equitably among its customers, and in order that the borrower may conveniently arrange his affairs with the knowledge that in normal times there will be money available for him, it is customary for many banks to give its customers a line of credit available for a year, although some banks feel that a borrower should pay off all his loans with a bank at least once a year. This line of credit is not a definite commitment to lend a given amount of money to a borrower, but it means that the bank, after careful investigation, feels that it can with safety lend a stated amount of money to the borrower during the year, if he desires it; it also implies that the bank considers that the customer has been keeping sufficient deposits with the bank to entitle him to

the use of such an amount of money. The borrower may not use his full line, or some emergency may come up and he may wish more for a short time.

Secured and Unsecured Loans.—There are various kinds of loans. Some are secured and some are unsecured so far as the physical deposit of collateral with the bank is concerned, although there is always some security of some kind to insure its repayment, or the loan would not be made. However, it is not always necessary or practical to deposit the collateral with the bank. When a loan is made without the deposit of collateral, it is known as a "clean" loan.

While custom and the character of the business dictate in a general way whether a loan shall be secured or "clean," in the final analysis, it is the honesty of the individual or corporation that secures the "clean" loan, or any other kind of loan for that matter; because, no matter what the nature of the business may be, a bank will not lend money if it has doubt of the integrity of the borrower or of his ability to repay.

Honesty and Integrity Vital.—A man on a small salary may need to borrow money because of sickness, or other misfortune, and if his honesty and integrity are well established, and if he can promise to repay in a prescribed time, a bank would be justified in loaning him a moderate amount on his note without collateral, a practice, however, not general in the larger cities. On the other hand, custom requires that when stock brokers borrow from banks, they must pledge collateral, with ample margin, irrespective

of their wealth and integrity, because of the possibly rapid fluctuation in market prices.

In some cases a bank may feel that it can with safety grant a concern a "clean" loan up to a certain amount, and a secured loan for anything over that figure.

Trade Acceptances.—An instrument of credit accommodation which has come into wide use since the inauguration of the Federal Reserve System is the acceptance. There are two kinds of acceptances, trade acceptances and bank acceptances, and in Great Britain and other European countries practically all commercial transactions are financed by means of time drafts or bills of exchange, which may be classed under the general heading of acceptances. Prior to the Civil War, trade acceptances were in general use in the United States, but after the close of that war, and during the period of financial disorganization which followed, the granting of time credits through trade acceptances became unpopular and led to the selling of goods on open book accounts with short time cash payments, a practice which continued very generally up to within the last few years. The advantages of trade acceptances over open book accounts are, however, so great that they are coming into favor again, and their use will doubtless increase largely as time goes on. Among other things, they release funds tied up in more or less non-negotiable open book accounts, and the relations between buyer and seller are improved by paper defining their respective rights and obligations with a definite date of payment. The right to make partial payments (which is one of the conveniences of open accounts) may be ar-

ranged with the bank. If, at maturity, the buyer finds it inconvenient to pay the acceptance in full and the seller desires to help him, he may do so by accepting the buyer's promissory note with interest, thus granting an extension without loss of interest which would result under the open account system.

While trade acceptances have certain advantages to the buyer in that they develop more careful habits in making purchases through having definite maturity dates at which to meet his expenditures, their chief advantage is to the seller, enabling him to avoid heavy borrowing and the tying up of capital and borrowed money in open accounts receivable, while by discounting eligible acceptances with banks it is possible to secure money at lower rates than obtain for straight promissory notes.

Trade acceptances are acceptable to banks because they represent sales actually made and are secured by two names, instead of one as in a promissory note, also, because eligible trade acceptances may be readily rediscounted with the Federal Reserve Bank. Under this method it is possible for banks to finance the sale of goods which under the other method the seller would be obliged to handle himself.

The definition of a trade acceptance is: "A time draft or bill of exchange drawn by the seller of goods on the buyer for the purchase price, and accepted by the buyer, payable on a certain date at a designated place." Therefore, when the seller desires to use the trade acceptance method, he draws a 30-, 60-, or 90-day draft on the buyer for each invoice, or for a month's transactions, according to the arrangements made. The buyer writes across the

face of the draft, "Accepted, payable at.....Bank," and returns it to the seller who can hold it until maturity; or if he is in need of funds, he can take the acceptance to his bank and have it discounted. By this latter method he can usually operate on less capital than when all of his receivables are open accounts, the collection dates of which may be uncertain.

Bank Acceptances.—Confusion frequently arises as to the difference between trade acceptances and bankers acceptances. Briefly, the trade acceptance is the result of a transaction between a purchaser and seller, the obligation to pay being acknowledged or "accepted" by the purchaser. The bank acceptance is the result of a credit granted by a bank or acceptance company, the instrument being "accepted" by a bank or acceptance company.

The definition of a banker's acceptance is: "A draft or bill of exchange of which the acceptor is a bank or trust company, or a firm, person, company or corporation engaged generally in the business of granting bankers' acceptance credits." When a merchant buys goods and wishes to borrow money on a banker's acceptance until they can be resold, he goes to his bank (or to an acceptance company) and arranges for the necessary line of credit. When it is time to pay for the goods, he draws a sixty- or ninety-day draft, which is "accepted" by his bank. He can then sell it either to his bank or in the open market, or, if he has arranged to do so, he can deliver it to the house from which he purchased the goods. The merchant pays a commission to the bank for accepting his draft, which then becomes two-name paper and is

readily discountable at an interest rate lower than the rate at which the merchant individually could borrow money. The financial strength of the "acceptor" is a factor in determining the discount rate; the greater that strength, the lower the rate.

Limits Banks May Accept for.—Banks are generally permitted to accept up to an amount equal to 50% of their capital and surplus, or, with permission of the Federal Reserve Board, up to 100%, but the aggregate amount of acceptances growing out of domestic transactions shall in no event exceed 50%. In addition, banks are permitted to accept up to 50% for the purpose of furnishing dollar exchange, which is separate and distinct from and not included in the limits placed upon the acceptance of drafts and bills of exchange above described.

Provisions Under Which Banks May Accept.—Under provision of Section 13 of the Federal Reserve Act, banks are permitted to accept drafts or bills of exchange drawn upon them which, excluding days of grace, have not more than 6 months' sight to run, if any one of the following conditions is observed:

The bill must:

1. Have its origin in a transaction involving the importation or exportation of goods; or
2. Arise from a transaction involving domestic shipment of goods and have shipping documents attached at time of acceptance securing or conveying title to the goods; or
3. Be secured at the time of acceptance by warehouse receipt or other such documents conveying or securing title to readily marketable staples.

Some other general provisions relating to acceptances are as follows:

A member bank is prohibited from accepting for any one person, firm, company, or corporation, whether in a foreign or domestic transaction, drafts or bills of exchange aggregating at any one time more than ten per cent of the capital and surplus of the member bank. The latter limitation has no application if the accepting bank remains secured either by attached documents or other actual security arising from the transactions covered by the acceptance. A bill of lading draft is actual security even after the documents have been released, provided the draft is accepted by the drawee upon or before the surrender of the documents. However, a trust receipt which permits the customer to have access to or control over the goods is not considered by Federal Reserve Banks to be "actual security" within the meaning of Section 13.

If the aggregate amount of drafts accepted for one person, firm, company, or corporation exceeds ten per cent of the capital and surplus of the accepting bank, such excess drafts must remain secured throughout their lifetime, and the security cannot be released unless other actual security growing out of the same transaction as the acceptance is substituted therefor. The accepting bank may, however, release the security if the total amount accepted for any one customer does not exceed 10% of its capital and surplus.

Drafts Drawn Against Exports or Imports.—A member bank may accept drafts drawn for the purpose of importing or exporting goods, whether or not the sale has

been consummated at the time of the acceptance, but the accepting bank must be reasonably sure that the draft is drawn to finance a transaction involving importation or exportation of goods; that its proceeds will be used for that purpose; and that there is a definite, bona fide contract that shipment will be made within a reasonable and specified time. If the accepting bank believes that the proceeds will ultimately be used solely for the purpose of financing the transaction involving the importation of goods, it is immaterial that the goods shall have been actually sold at the time of the acceptance; it is not even necessary that the goods be identified at that time.

National banks cannot accept drafts for the purpose of enabling domestic concerns to extend credits on open account to foreign purchasers.

A member bank cannot accept drafts drawn by an exporter in a foreign country to provide funds for the purchase of farm products from farmers in such country unless the foreign exporter has a contract to ship the commodities in question to some other country. Unless the member bank has a guaranty to this effect, the transaction is not one involving importation or exportation of goods, and the fact that the foreign exporter intends to sell the goods in a foreign country is not sufficient. An actual contract of sale must exist and it must appear that the drafts are merely drawn in advance of the actual shipment of goods under the contract of sale.

If fully secured, a member bank may accept drafts drawn by a domestic firm, having a contract to sell to foreign buyers, if the transaction is made in good faith,

though it may result in the ultimate sale of the goods to an American instead of to a foreign purchaser.

Maturity of Drafts.—Although the Act fixes a maximum maturity of 6 months, yet when a draft is drawn against a shipment of goods in a transaction not involving the sale, the maturity of the draft should approximate the duration of the transit of the goods, the law contemplating that the acceptance should be to finance the shipment and that it should not be the means of furnishing a credit for any other purpose.

When a draft is drawn against the shipment of goods in a transaction involving their sale, the draft may be drawn and accepted for the purpose of financing, not merely the shipment but also the sale of the goods. In this connection, it has been held that a draft drawn against goods shipped from a corporation to its agent may be accepted by a member bank even though no actual sale is involved.

Security of Drafts.—The provision which authorizes member banks to accept drafts based on domestic shipments of goods when shipping documents are "attached," does not mean that the documents must be physically fastened to the draft. Shipping documents must, however, be made out or endorsed so as to convey or secure title to the accepting bank.

No draft which is secured by a warehouse receipt should properly be considered eligible for acceptance under the terms of Section 13 of the Federal Reserve Act unless the goods covered by the warehouse receipt are be-

ing held in storage pending a reasonably immediate sale, shipment, or distribution into the process of manufacture. Any draft, therefore, which is drawn for the purpose of carrying goods for speculative purposes or for an indefinite period of time, and without the purpose to sell, ship, or manufacture within a reasonable time, should not be considered eligible for acceptance under the provisions of Section 13. Such a draft would be merely a cloak to evade the restrictions of Section 5200 of the Revised Statutes and is not an instrument which Congress intended to make eligible for acceptance.

Release of Shipping Documents.—When a draft is secured by a warehouse receipt, it may be necessary at some period during the life of the draft to surrender the receipt to the customer for whom the acceptance was made, in order that the transaction involved may be consummated, and it is ordinarily necessary to release the shipping documents at an earlier period than is the case with warehouse receipts; in any event the security should not be surrendered until it becomes necessary. When the documents are surrendered, the bank should protect itself by procuring either a trust receipt or a definite agreement on the part of the customer to whom the security is surrendered, that the proceeds derived from the sale of the goods represented by the shipping documents or warehouse receipts will be deposited with the accepting bank when available to pay the draft at maturity, and will not be used by the customer for other purposes. When a trust receipt is substituted, the ten per cent limitation applies, if the receipt is of such a character as to give

to the customer for whom the draft was accepted access to or control over the goods, since such a receipt is not regarded as "actual security" within the meaning of Section 13 of the Federal Reserve Act.

It is a sufficient compliance with the terms of the Federal Reserve Act if shipping documents are in the possession of the accepting bank and if it has a lien on the property represented by the documents at the time the bill is accepted. If placed in the possession of the bank's agent and under the control of the bank, such documents may be considered as in the possession of the bank.

Propriety of Borrowing.—Some people have a horror of debt, and others try to borrow more than they should, but there is a happy medium which is essential and necessary for the transaction of business. If there were no loans, banks would not have sufficient income to operate and there would be no banks.

In the average business there are usually certain seasons of the year when more money is required than at other seasons, and if an amount of capital were provided so large that it would never be necessary to borrow money, there would be certain seasons of the year when idle money would accumulate. With such concerns it is usually desirable to proportion their capital to their requirements in normal times and then to borrow money during the seasons when larger funds are required.

Continuous Borrowers.—Certain concerns never have enough capital, and are continuous borrowers. This course may answer for a while, but if money gets scarce

they are liable to find that they cannot renew their loans and the course may end in receivership.

A certain amount of borrowing for legitimate purposes indicates a healthy condition of business, and it is well known that money piles up in banks during periods of poor business, and bond prices advance because of the greater demand for bonds for investment purposes; while during periods of business activity, when there is an increased demand for money, bond prices are apt to decline.

As has been said, moderate borrowing denotes a healthy condition of business; if it becomes excessive, it produces inflation which usually precedes a period of business depression.

Dread of Interview with Bank Officers.—Possibly as a result of tradition, many men stand in awe of their bank and maintain no more contact with it than is absolutely necessary; others have the impression that a bank is out to extract the last cent possible from people who need to borrow money, and feel that the less they have to do with a bank the better off they are.

There may be some banks that are not as progressive as they should be, but keen competition has gradually created a different atmosphere in modern banks, and they are glad to co-operate with customers in working out problems when the customers are willing to put the facts frankly before their bankers.

Fundamentally, each bank can do the same class of business, and, therefore, one bank should be able to serve its customers as well as another. Consequently, a bank's only arguments to attract business are its soundness, its

broad-minded policy in dealing with customers, its ability to render the best service possible, and the intelligence and courtesy of its officers and clerks.

Bank's Need of Making Money.—A bank must make money, and out of what it charges for interest on loans, it must pay all of its operating expenses, and taxes; must earn a return on the capital invested in the bank, and if it pays interest on deposits, must earn funds for this purpose. It must also set aside a reserve to cover bad debts contracted in the course of business. There are very few businesses that do not have some bad debts, and a bank is no exception to the rule, no matter how careful its officers may be.

It is a natural consequence that the average man prefers to deposit his money with a bank that is making money, and the ideal situation is for a depositor to own some stock of his bank—even if only one or more shares—so that he may have a part in its prosperity, which he helps to create.

Banks Desirous of Lending Money.—Remember that a bank is just as desirous of lending money, providing it can do so safely and at a fair rate, as a customer is to borrow it, and if the borrower can safely and profitably use the money, there is no reason why he should not borrow in moderation and in accordance with his circumstances. In fact, there is every reason why a customer should interview his bank on the subject, as the bank cannot well approach its clients and ask them to borrow money

This is not an argument for promiscuous borrowing, but merely a suggestion to the man who may be unduly cramping his business, rather than ask for a loan which may both help him and, at the same time, be good business for his bank.

CHAPTER III

IMPORTANT FOR BANKS TO BORROW—FUNCTIONS OF FEDERAL RESERVE SYSTEM

Eligible Paper.—It is obvious that a bank should have as many as possible of its loans in eligible form, so that it can rediscount them with the Federal Reserve Bank when it is in need of money. To assist in this process and to make their loans more desirable to the bank, borrowers should, as far as possible, see that their paper is eligible for rediscount.

For a note, draft, or bill of exchange to be eligible for rediscount it must come within the following requirements:

1. It must be a note, draft, or bill of exchange which has been issued or drawn, or the proceeds of which have been used or are to be used in the first instance, in producing, purchasing, carrying, or marketing goods in one or more of the steps of the process of production, manufacture, or distribution, or for the purpose of carrying or trading in bonds or notes of the United States.

2. It must not be a note, draft, or bill of exchange the proceeds of which have been used or are to be used for permanent or fixed investments of any kind, such as land, buildings, or machinery, or for any other capital purpose.

3. It must not be a note, draft, or bill of exchange the proceeds of which have been used, or are to be used, for

investments of a purely speculative character, or for the purpose of lending to some other borrower.

4. It may be secured by the pledge of goods or collateral of any nature, including paper, which is ineligible for rediscount, provided it is otherwise eligible.

5. It must have a maturity at the time of discount of not more than 90 days, exclusive of days of grace; but if drawn or issued for agricultural purposes or based on live stock, it may have a maturity at the time of discount of not more than nine months, exclusive of days of grace.

6. It must arise out of an actual commercial transaction; that is, it must be a note, draft, or bill of exchange which has been issued or drawn for agricultural, industrial, or commercial purposes, or the proceeds of which have been used, or are to be used, for such purposes.

7. It must not be issued for carrying or trading in stocks, bonds, or other investment securities, except bonds and notes of the Government of the United States.

8. The aggregate of notes, drafts, and bills bearing the signature or endorsement of any one borrower, whether a person, company, firm, or corporation, rediscounted for any one member bank, whether State or National, shall at no time exceed 10% of the unimpaired capital and surplus of such bank; but this restriction does not apply to the discount of bills of exchange drawn in good faith against actually existing values.

Definition of Nine Months' Agricultural Paper.—Nine months' agricultural paper, within the meaning of the Federal Reserve regulation, is defined as a note, draft, bill of exchange, or trade acceptance drawn or issued for

agricultural purposes, or based on live stock; that is, a note, draft, bill of exchange, or trade acceptance the proceeds of which have been used, or are to be used, for agricultural purposes, including the breeding, raising, fattening, or marketing of live stock; and which has a maturity at the time of discount of not more than 9 months, exclusive of days of grace.

Trust Receipts.—It frequently happens as a practical matter, that, for one reason or another, a merchant or manufacturer must retain the physical possession of goods for which he has been granted a credit by a bank. It may be a car load of hides, for instance, which he desires to convert into leather, or a shipment of goods to be exhibited for sale, and it would be impracticable to conduct the sale and make piece-meal deliveries from the warehouse where the bank might be holding the goods as collateral. While laws vary in different states, in some states it is possible to overcome this difficulty, and a bank having title to such goods may release them on trust receipt, which means that the bank retains its title to the goods but delivers the physical possession to the merchant. While the bank is without physical possession of the collateral and is trusting the merchant with it for the bank's account, it is not actually a "clean" loan because, should the merchant become bankrupt when goods are out on a trust receipt, the bank would have prior claim on the goods until its loan is paid, while in the case of a "clean" loan, the bank would share with the other general creditors.

When goods are released on trust receipt it is the duty

of the merchant or party to whom they are released to "ear-mark" them so that they can always be identified as the property of the bank, until its claim is discharged. In this way the merchant can identify the goods when sold and apply the proceeds from the sale to pay off the loan. The proceeds from the sale of such goods must not be mingled with the other assets of the merchant, because to do so would be obviously a misappropriation of funds.

To refer again to the hides, each hide would be properly tagged, so that in the different processes of converting it into leather it would always show that the title remained in the bank.

While a trust receipt in one sense virtually implies a clean line of integrity, in that the bank is trusting its customer in permitting him to have the custody of the goods with the understanding that he will pay the bank as he receives the proceeds from the sale of the goods covered by the receipt, in reality, if the customer is honest and the goods do not unduly depreciate in value, the bank is sure of its money even though the customer meets with financial reverses and the general creditors receive little or nothing, because the bank has title to the goods until its claim is satisfied.

Banks as Borrowers.—Banks, as well as their customers, should be borrowers, as that is the method provided under the Federal Reserve Law as the means for increasing the amount of money in circulation during times of business activity, through the issuance of Federal Reserve notes.

If it is assumed that the amount of money in circulation in normal times is sufficient to take care of business needs at such times, then in times of greater business activities and at seasons when crops must be moved, etc., banks should borrow from the Federal Reserve Bank in order that larger funds may be placed in circulation to take care of the increased demand. Care must be exercised, however, that the amount of these borrowings shall not be too large, or stay out too long, as a continuing period of too easy money is likely to produce inflation.

In other words, a Federal Reserve Bank and an ordinary bank stand in about the same relationship to each other regarding borrowing as do a bank and its customers. If the customer is depending too much on borrowed capital to run his business, it may produce trouble for him when money is not plentiful. In the same way, if a bank borrows too freely from the Federal Reserve Bank in normal times, in trying to do more business than it should, it may become "extended," and if this condition becomes general with all banks, unhealthy financial conditions are produced throughout the country.

Elasticity in Currency.—A currency system, to be beneficial to the business world, must have elasticity; that is, it must be one which can be readily expanded at times when there is need for more than the normal amount of money in circulation (as, for instance, during the crop-moving season), and which will automatically decrease to normal proportions again when the demand subsides.

This elasticity is provided for in the American cur-

rency system under the Federal Reserve Act. Paper (customers' notes) arising out of a business transaction, subject to certain restrictions making it eligible, can be taken by a member bank to a Federal Reserve Bank and can there be exchanged for Federal Reserve notes. The Federal Reserve Bank in turn pledges with the United States Government the paper so received, at 60% of its face amount, together with 40% in gold for the Federal Reserve notes issued as mentioned above.

By this system, when a bank has loaned out all its available supply of money it can take to the Federal Reserve Bank any notes of its customers that are eligible for rediscount and receive an additional supply of money.

When this rediscounted paper matures and is paid off, Federal Reserve notes in equal amount are retired, and if the demand for additional money has declined and no additional paper is rediscounted, the outstanding amount of Federal Reserve notes is automatically decreased.

Retirement of Federal Reserve Notes.—In theory, the Federal Reserve notes issued when the individual's note was discounted, or pledged, with the Federal Reserve Bank, would be used to pay off such note at its maturity and the individual would get back his note and the Federal Reserve Bank would get back the Federal Reserve notes it had issued, which would then be sent to Washington for redemption and cancellation.

As a practical matter, it is not possible to use the identical Federal Reserve notes to pay off the individual's note

at maturity, nor is it practicable always to pay off the note with the Federal Reserve notes which have been issued through any particular Federal Reserve Bank. Therefore, Federal Reserve notes issued through any Federal Reserve Bank can be used for this purpose, so that the individual is relieved of the burden of securing any particular Federal Reserve notes and the problem of sorting out the notes falls to the Federal Reserve Banks.

As a matter of practice, the individual merely gives his check to the bank which takes his note in the first place and the bank makes the necessary settlement with the Federal Reserve Bank. This assorting of the notes of the Federal Reserve Banks is accomplished by a requirement that all Federal Reserve notes issued through one Federal Reserve Bank and received by another Federal Reserve Bank must be promptly returned to the Federal Reserve Bank through which they were originally issued or, upon instructions from such bank, must be sent direct to the Treasurer of the United States to be retired.

In this way, each Federal Reserve Bank can regulate the amount of its Federal Reserve notes to be retired and keep the total amount outstanding in conformity with the amount of paper pledged thereunder. Of course, when a Federal Reserve Bank takes in Federal Reserve notes issued through some other Federal Reserve Bank, it is paid —or receives credit—for all such Federal Reserve notes as it returns to the original bank or sends to Washington for retirement.

The amount of Federal Reserve notes which can be issued in this manner is limited to the amount of gold in

possession of the Federal Reserve Banks, because the Federal Reserve Banks must supply 40% in gold, although the Federal Reserve Board has the right to suspend this requirement under certain conditions, including the payment of a penalty tax.

CHAPTER IV

SOME PITFALLS IN BUSINESS

Bank Vitally Interested in the Success of Its Depositors.—A bank is interested in the success of its depositors, because as their business grows it produces increased business for the bank. Customers should consult freely with the bank officers if for no other reason than that they are jointly interested in the success of the business.

A man may be an expert in manufacturing and selling goods, but may have only a limited knowledge of financial matters. On the other hand, bank officials are not only trained in financial matters, but through constant intercourse with all kinds of business are also well-versed in commercial matters, and if the business man will only view the matter in the right way, he can secure the highly-specialized services of trained men merely by laying his problems honestly before his banker. If the advice is contrary to the inclinations of the customer, it is but just to remember that it is because the bank desires to see the business conducted on a safe basis, and surely the customer desires safety above everything else, as otherwise he may lose his all.

The great majority of men are honest, whether they be farmers, storekeepers, or officers of corporations, and usually financial disaster comes from ignorance or incorrect information concerning business conditions and

methods; therefore, the very least a man can do is to draw on the knowledge of his banker to supply him with what he himself lacks in financial knowledge.

Even if a business is small a customer should not be deterred from consulting his banker, as usually the man with the small business is more in need of financial advice than are those engaged in larger operations, who may have had more extensive experience along financial lines. No man, whether his business is large or small, should have any hesitancy in consulting with his bankers. There are many cases where ultimate financial difficulties could have been avoided if the customer, in the early stages, had taken his troubles up with his bank.

Some Causes of Bankruptcy—Inaccurate Cost Accounts.—Bankruptcy can come from various causes. It may come from operating losses, and if so there is usually more warning than when some other factor is the cause. It may come from destruction of property, when the insurance carried has not been sufficient. It may come from a sudden and extensive drop in prices, when there is a large stock of goods on hand. During the year 1921, American business afforded many illustrations of this, and many concerns charged off amounts up into the millions for shrinkage in inventories. Just before that year, business had been enjoying a period of unheard-of prosperity, and the majority of concerns were able to weather the storm without outside assistance, but others which had paid out too much in dividends or had dissipated their cash resources in permanent investments or unwise advances, were forced to the wall.

Inaccurate cost accounts or lack of cost accounts, have probably been responsible for more failures than any other one cause. Of the two, the lack of cost accounts is probably less harmful than inaccurate figures, because with inaccurate cost data, a company bases its conclusions upon incorrect information, while with no cost accounts, the company at least knows that it is working in the dark. Proper cost accounts are absolutely essential to the safe conduct of business, unless the margin of profit is so great that it may not be vitally necessary to watch the costs. It need hardly be said, however, that it is always desirable to know the facts.

Danger of Locking Up Working Capital.—Probably the most insidious cause of bankruptcy, and one that usually has made serious progress before it is recognized, is, in normal times, the dissipation or locking up of current assets in permanent investments for the purpose of expanding the business, or in paying out too much in dividends. As a safeguard against these dangers every business concern should prepare and keep as a standard reference, a properly balanced Balance Sheet adapted to its own particular kind of business, and should, monthly or semi-annually, compare this with the actual Balance Sheet of the business in order to note wherein the actual conditions vary from the standard. If this is done, corrective measures can be taken as soon as danger signs appear, without waiting until a crisis is reached. If the inventory is unduly large, investigation should be made to see if it is because prices are higher or if goods are piling up from lack of sales, or whether there is some weak spot

in the shops which is retarding the completion of the product and slowing down deliveries. If it is due to increased prices, then investigation should be started immediately to see whether it is a temporary condition or whether it is more or less permanent and likely to require more money permanently in the business.

If the business is expanding and it is necessary to have a larger amount of accounts receivable, or more materials on hand, or if extensions to the plant are required, then a sufficient amount of earnings should be added to surplus account to provide the cash for this purpose; or, in lieu of reserving earnings, additional capital should be procured and invested in the business.

Idle Capacity.—Idle capacity may also be an important factor in producing bankruptcy, and an ideal method to ascertain the amount of it is to arrange the cost accounts so that each month all idle capacity costs are accumulated in one account, thereby ascertaining the cost of the product as if the organization were running at full capacity. Then add, as a general overhead charge to the production for the month, the cost of the idle capacity for such month. In this way it is possible to determine both the cost of goods as if production were running at full capacity, and to find what they have actually cost because of a certain amount of idle capacity. The advantage of this method is that it enables one to see the possible cut which can be made in sale prices to obtain more business and thereby procure additional profits by bringing the plant up to full capacity.

Dangers of Advancing Prices.—A man may watch his stock of goods carefully to see that he does not increase the quantity on hand over the normal amount, yet if the goods have advanced 10% in price over the previous year, the amount carried as inventory will increase proportionately, and he will require that much more money to carry the same quantity of goods that he had on hand the preceding year. The money must be had, and it can come only from three sources—a greater amount of profits left in the business, an increased amount of capital placed in the business, or increased loans.

A similar condition will exist with the Accounts Receivable, because when prices advance a greater amount will be outstanding in Accounts Receivable for the same quantity of goods sold than would be the case at lower prices, which, of course, means that more money is required to run the business.

Dangers from Surplus Money Accumulating as a Result of Decline in Prices.—A decline in prices may also have its dangers, because at such a time there is a shrinkage in the amount of money tied up in Inventories and Accounts Receivable. Unless this condition is recognized, a business man may find himself with an unusual amount of cash on hand which was formerly tied up in inventory, etc., and without much thought about the wisdom of doing so, he may invest it in some long-cherished plans for extension of the plant, with the result that when prices again become normal he will suddenly find himself short of money, and will be in the same position as if he

had ill-advisedly locked up current money in bricks and machinery during normal times.

Difference Between Inventories and Other Kinds of Current Assets.—As concrete illustrations are more helpful in making a careful study of the financial condition of one's business than any amount of general comment on the subject, there are submitted in the following paragraphs certain figures and criticisms which it is hoped will bring out clearly the principal danger points enumerated.

In a careful analysis of the financial condition of a business, there is an important distinction between the amounts carried in inventories and the amounts carried in good Notes, and Accounts Receivable, as the latter can be realized on more quickly than the merchandise. Notes Receivable can be discounted and frequently Accounts Receivable can be converted into Notes Receivable when a concern wishes to secure funds by discounting its Notes Receivable, while the inventory in a manufacturing business must be worked up into the finished product and sold. Furthermore, inventories require a constant investment of funds (sometimes larger at one time than another) while the Receivables are more flexible, as they are available for discount.

Review of a Balance Sheet.—Just recently a review was made by a certain bank of a Balance Sheet of a company desiring to open a new account, to secure an additional line of credit. In this case, the percentage of the

company's total Current Assets (including inventories) to Current Liabilities showed a satisfactory ratio and yet the ratio of Cash and Accounts Receivable to Current Liabilities was only 46%. As a matter of fact a bank had for years been assisting this company in running its business by permanently supplying it with capital in the form of loans. These figures are shown below as of the "X Company."

Assets	X Company Actual Condition	A Safe Condition	Increase	Decrease
Cash	$ 340,510	$ 150,000		$ 190,510
Accounts Receivable	392,650	392,650		
	$ 733,160	$ 542,650		$ 190,510
Raw Material	1,775,500	1,775,500		
Goods in Process	945,300	945,300		
Finished Goods	410,800	410,800		
Total Current Assets	$ 3,864,760	$ 3,674,250		$ 190,510
Advances to Subsidiary Companies	995,000	200,000		795,000
Investments	215,000	1,010,000	$795,000	
Plant, Machinery, etc.	5,850,000	5,850,000		
Office Building	450,000	450,000		
Total Assets	$11,374,760	$11,184,250		$ 190,510
Liabilities				
Accounts Payable	$ 45,853	$ 45,853		
Bank's Loans	1,550,000	400,000		$1,150,000
Total Current Liabilities	$ 1,595,853	$ 445,853		$1,150,000
Mortgage on Building	225,000	225,000		
First Preferred Stock	2,000,000	4,500,000	$500,000	
Second Preferred Stock	2,000,000			
Common Stock	4,000,000	4,500,000	500,000	
Surplus	1,553,907	1,513,397		40,510
Total Liabilities	$11,374,760	$11,184,250		$ 190,510
Ratio to Current Liabilities of:				
Cash and Accounts Receivable	46%	121%		
Current Assets	242%	824%		

The average business man might not see anything very alarming in the foregoing Balance Sheet; in fact he might feel well satisfied with it as the ratio of current assets is 2.42 times current liabilities. But if the company were called upon to pay its loans, it could not do so, except by going into liquidation or securing additional capital. Furthermore, if prices advanced, it would require considerably increased funds to do business; that is, it would need more money to carry the same stock of goods and the same volume of Accounts Receivable.

The principal dangers which this Balance Sheet indicates are:

(a) That in the particular kind of business which it represents the large inventories shown must be carried continuously, consequently necessitating a permanent tie-up of capital for that purpose, practically the same as if the investment were in plant.

(b) That the $995,000 shown represents advances to a subsidiary company, of which only $200,000 was for temporary seasonal borrowing, while the balance was permanently used by the subsidiary for operating purposes, i.e., was a "frozen" loan.

A bank must keep its loans liquid so that it will receive payments when they are due; therefore it should not have money permanently invested in a business. In this instance, the bank could not get its money except by forcing the company into liquidation. An alternative, of course, would be for the company to raise more capital, but at a time when banks are calling loans it is difficult to raise additional capital. Therefore, for its own protection, the company should provide the requisite amount of per-

manent capital for itself and its subsidiaries when it is easy to borrow money, because at such times there is usually more money available for permanent investment.

With ample capital a company is independent of a bank during periods of tight money, and if it does require money at such times it can probably secure it without difficulty, as its paper would (if in the eligible class) be readily rediscountable at the Federal Reserve Bank, while at the same time the bank might be endeavoring to get some other company (like the X Company of the Balance Sheet) to reduce its loans, because such company was not really liquid and the lending bank would naturally be fearful of having a "frozen" loan when it needed the money.

(c) That if prices should advance, the company would require more money to transact the same volume of business, and a bank would hesitate to make further advances to the X Company; in fact, it should already be urging the company to get in a more liquid condition.

(d) That the company has outstanding too many classes of stock for a small company. The total amount authorized of each kind has been issued. Both the first and second preferred stocks carry cumulative dividends, the second preferred being callable and the first preferred not callable and having equal voting power with the common, all of which makes a rather complicated structure for additional financing.

Looking at this matter entirely from the side of the X Company, the officers handling its finances would unquestionably feel more comfortable if they had more capital in the business so that the loans would be less and the company in a better "quick cash" condition.

CHAPTER V

MEANS OF WATCHING AND TESTING FINANCIAL CONDITION

Need for a Business to Know Its Real Condition.—It is probable that the majority of business concerns are not entirely satisfied with their financial condition. Others through ignorance, may be satisfied when they should not be.

There are also many degrees of condition, some better than the average, and some worse than the average; some in which it is possible to produce a satisfactory condition immediately by further financing and others in which the improvement must be gradual; and in some cases it may be necessary for the banks to co-operate with their customers.

In any event, it is of vital importance that the officers of a business should know what its real condition is, and one way of testing conditions is to have a Balance Sheet drawn up on a basis of what may be considered an ideal condition for the business and then from time to time to compare the actual Balance Sheet with it to note the differences.

As time goes on the officers should watch to see whether the condition of the business is improving or getting worse. This can be done by comparing the present Balance Sheet with those for earlier periods.

Comparative Illustrations.—To illustrate this point more clearly, two examples are shown below. Example No. 1 represents a business whose condition has improved during the year; Example No. 2, one whose condition has become worse.

Example No. 1

Comparative Balance Sheets Dec. 31

Assets	1922	1921	Increase	Decrease
Cash	$ 45,000	$ 50,000		$ 5,000
Accounts Receivable	260,000	255,000	$ 5,000	
	$305,000	$305,000		
Inventory at Cost or Market, whichever is lower	325,000	325,000		
Total Current Assets	$630,000	$630,000		
Plant Investment	280,000	275,000	5,000	
Total Assets	$910,000	$905,000	$ 5,000	
Liabilities				
Accounts Payable	$100,000	$100,000		
Unpaid Wages	15,000	15,000		
Loans Payable	162,000	185,000		$23,000
Total Current Liabilities	$277,000	$300,000		$23,000
Capital	500,000	500,000		
Surplus	133,000	105,000	28,000	
Total Liabilities	$910,000	$905,000	$ 5,000	
Ratio to Current Liabilities of:				
Cash and Accounts Receivable	110%	101%		
Total Current Assets	228%	210%		

Surplus Account

Credit Balance at beginning of year	$105,000
Net Profits for year	53,000
	$158,000
Dividends or Profits Distributed	25,000
Credit Balance at end of year	$133,000

Example No. 2

Comparative Balance Sheets Dec. 31

Assets	1922	1921	Increase	Decrease
Cash	$ 45,000	$ 50,000		$ 5,000
Accounts Receivable	260,000	255,000	$ 5,000	
	$305,000	$305,000		
Inventories at Cost or Market, whichever is lower	350,000	325,000	25,000	
Total Current Assets	$655,000	$630,000	$25,000	
Plant Investment	325,000	275,000	50,000	
Total Assets	$980,000	$905,000	$75,000	
Liabilities				
Accounts Payable	$100,000	$100,000		
Unpaid Wages	15,000	15,000		
Loans Payable	247,000	185,000	$62,000	
Total Current Liabilities	$362,000	$300,000	$62,000	
Capital	500,000	500,000		
Surplus	118,000	105,000	13,000	
Total Liabilities	$980,000	$905,000	$75,000	

Ratio of Current Liabilities vs.:		
Cash and Accounts Receivable	84%	101%
Total Current Assets	181%	210%

Surplus Account

Credit Balance at beginning of year	$105,000
Net Profits for year	53,000
	$158,000
Dividends or Profits Distributed	40,000
Credit Balance at end of year	$118,000

STATEMENT OF RESOURCES FOR THE YEAR 1922 AND THE DISPOSITION MADE OF THEM

Resources	Example No. 1	Example No. 2
Net Profits for year	$53,000	$ 53,000
Increase in amount of Borrowed Money	0	62,000
Total Resources	$53,000	$115,000
Disposition of Resources		
Dividends Paid	$25,000	$ 40,000
Increase in Plant Account	5,000	50,000
Increase in Inventory	0	25,000
Decrease in amount of Borrowed Money	23,000	0
Total as above	$53,000	$115,000

In Example No. 1, a small amount has been expended for additional plant facilities and a distribution in the form of dividends has been made at the rate of 5% on the capital, with the result that it has been possible to reduce the amount of borrowed money by $23,000.

In Example No. 2, the plant cost has been increased by $50,000; dividends of 8% have been paid amounting to $40,000; and the inventory has been increased $25,000. In order to make possible these expenditures, it was necessary to borrow $62,000 more. A continuation of such policy, without additional capital or accumulated profits, is sure eventually to bring ruin to the business.

Accounts as a Barometer.—Many men look upon their books of account as more or less a nuisance, a necessary evil which has to be put up with, instead of realizing that the accounts can be made to reveal a true picture of what the business is doing, can be regarded as a barometer which, properly studied, will reveal dangerous ten-

dencies. This has been discussed fully in the preceding section, in which is given also a Resource and Disposition Statement. Such a statement is a condensed summary of the financial changes during a given period and tells the story more clearly than a mere comparison of Balance Sheets can show it.

To prepare such a Resource and Disposition Statement, the Balance Sheets at the beginning and end of the period under consideration should be listed in two columns side by side, with two additional columns to note the increases and decreases in the assets and liabilities between the two dates.

The *increases* in the various liability accounts and the *decreases* in the various asset accounts represent the resources available for the period and should be listed under the heading of Resources.

The *increases* in the asset accounts and the *decreases* in the liability accounts represent the disposition made of the resources and should be listed under the heading of Disposition.

Analysis of Surplus Account.—A further segregation should, however, be made in the Surplus account, which would appear among the Resources, if it shows an increase during the given period. If, on the other hand, the Surplus account shows a decrease, it should appear among the Disposition items. The principal changes in the Surplus account should be analyzed and the Net Earnings or Net Profits entered under Resources in place of the amount representing the increase in the Surplus, and the amount of dividends paid and depreciation charged off,

and any other similar item of importance should be entered among the Disposition items. This analysis of the Surplus account is desirable so that the picture will show on one side the profits for the year, and on the other side the proportion of the profits used for dividends, depreciation, etc., and the amount added to Surplus account.

Attitude of Business Builder to His Cash Position.—Builders of large businesses are usually men of great imagination and optimism, and not infrequently they are impatient of all the detailed ways and means necessary to accomplish the purpose, among which, too often, such men include proper financial arrangements. Business is there to be had and attention is concentrated first on securing it, then on expanding the facilities to handle it, and the cash end may not be thought of at all until the supply runs low or the bank refuses to make further loans.

Proper financial arrangements are essential—in fact, vital and no plan of expansion should be undertaken without the knowledge not only of the amount of money required and where it is to come from but also, that it will be available when needed.

When to Borrow for Inventories.—Comment has been made regarding the undesirability of tying up borrowed money indefinitely in inventories, but this does not mean that a business should never borrow money for inventory purposes, as there are many lines of business in which the inventory is much larger at certain times of the year than at others, and it is perfectly right and

proper to borrow to carry goods over the peak periods. That is a self-liquidating proposition, and is very different from investing borrowed money permanently in inventory.

In addition to seasonable periods of high inventories, such as have been spoken of, there are also times when goods are unusually cheap, and if the element of time does not produce deterioration in value, it may be desirable to lay in sufficient stock to last a considerable period, such items as copper, pig iron, and other non-perishable commodities being in this class. The successful merchant or manufacturer is usually blessed with a certain amount of foresight which assists him in stocking up when goods are low and keeping his purchases at a minimum when goods are high.

While certain other business men may not have this faculty so well developed, it would seem that when goods are selling at less than the cost of production in normal times (which occasionally happens) a business cannot go far wrong in laying in a sufficient supply to last a considerable period, providing there is sufficient money for the purpose. If not, it would be entirely reasonable and proper to discuss the situation with the bank, to see how much money it would be willing to lend for such a purpose and for how long a period.

The important point in a matter of this kind is to take it up with the bank and learn its views on the subject before entering into any extensive commitments, rather than to go into them without proper financial arrangements and possibly later find that the bank is unwilling to make the loans necessary to carry the stock.

Banks Unable to Lend Always.—There are times when a bank must refuse to make a loan even though it is perfectly good in every respect because, as explained elsewhere, a bank must always keep in a liquid condition, and it may not have money to put out at the time such loan is desired. Furthermore, it must deal fairly with all customers, and it would hardly be just to lend a considerable sum to some depositor who had never carried a large deposit account and, because of such loan, be unable to lend to some other depositor who had been maintaining a good account. When conditions are normal, many banks figure that a depositor is entitled to borrow an amount equivalent to five times the average deposit maintained by him for some time past, providing of course that the loan itself is safe.

More Than One Bank Account.—There are also certain legal restrictions as to the amount a bank can lend to any individual or corporation.

For these reasons, it is frequently advantageous for a business to have more than one bank account. If the capital and surplus of a local bank are small, a condition which naturally restricts the amounts it can lend to any one concern, it may be desirable to carry one or more accounts in a large city. Usually it is desirable to open such accounts through the introduction of the local bank, which should be in position to give a satisfactory letter of introduction and supply the credit information required by the larger banks.

Sometimes local banks arrange with their correspondent banks in larger cities to carry excess lines for

their customers, and in many cases this method is well suited to the seasonal needs of a local business concern. On the other hand, the larger banks naturally consider the credits available for a local bank in proportion to the balance carried by the latter. Thus, unless the local bank carries a commensurate balance to cover all excess lines desired, the local concern may be more restricted in the amount it can borrow than if it should establish direct contact with a larger bank by carrying an account with it as well as with the local bank.

Note-brokers.—Note-brokers also perform an essential service in the matter of excess lines. Banks frequently have surplus money to put out but, as previously mentioned, they cannot very well go out and ask their customers to borrow. However, they can purchase good commercial paper through note-brokers even though the maker of the note has no account with the bank. Sometimes, as a result of the class of accounts carried or for other reasons, one or more banks may have idle funds, while other banks in the same locality may have all of their funds loaned out to regular customers. Under these circumstances note-brokers can be of service to banks in assisting them to keep their money working, and to business concerns in placing their excess lines. On the other hand, business concerns should not rely entirely on note-brokers when borrowing, because when money is not plentiful, banks will naturally take care of their regular customers first, and note-brokers may find it difficult to place their paper.

CHAPTER VI

BANK'S ANALYSIS OF BORROWER'S CREDIT

Information a Bank Desires When Granting Credit.—In considering a line of credit for the average business, a bank usually desires the following information:

1. Latest available Balance Sheet; also Balance Sheets for preceding two or three years, if they are not already in possession of the bank. Accounts should be grouped on Balance Sheets to show the Current Assets and Current Liabilities separately from the other Assets and Liabilities. The items in the former group should include the following accounts:

Current Assets	Current Liabilities
Cash in office and in banks	Notes Payable—Banks
Cash margin with banks	" " Brokers
Cash deposits in foreign countries	" " for merchandise
Cash advances for goods not invoiced	Accounts Payable—due within one year from date of Balance Sheet
Cash in Sinking Fund to be utilized within one year	Pay Rolls due and accrued
Certificates of Deposit with banks	Reserves for Bad Debts
Foreign Exchange	Reserves for Inventory Losses
Notes Receivable of Customers	Reserves for Contingencies
Accounts Receivable of Customers	Customers' Deposits
Raw Goods	Accrued Interest Payable
Goods in Process	Dividends Payable
Manufactured Stock	Chattel Mortgages
	Notes or Accounts Payable to affiliated or associated companies

Goods in Transit, if included in Accounts Payable
Goods on Consignment
Government or Municipal Bonds
Other Temporary Investments if readily convertible into cash
Accrued Interest Receivable

All other Liabilities, the maturity of which is not specified, except Capital Stock
Bonds or Mortgages maturing within one year

2. Statement of the manner of valuing goods in inventory. Inventories should be at cost or market, whichever is lower.

3. Amount of Insurance carried on plant and the amount on merchandise.

4. Amount of Notes and Accounts Receivable, past due or of doubtful value.

5. Statement of amount, if any, of Notes Receivable, Accounts Receivable, or Merchandise pledged to secure indebtedness.

6. Amount of Notes Receivable under discount; also any other contingent liability, as endorser or otherwise.

7. Full and clear explanatory notes of all unusual items in Balance Sheet, to insure fair consideration of them by the bank. Otherwise the bank, in order to be on the safe side when there is ambiguous wording or lack of detailed explanation, will classify such an item as *slow* assets, if it is an asset, or among the *current* liabilities, if it is a liability.

8. Statement of any contemplated construction or capital expenditure during the year, and the means by which it will be financed.

9. Earnings statements and Profit and Loss statements for a period of at least three years. A simple and convenient universal form for this purpose is as follows:

Comparative Earnings Statement

	Year 1923	Year 1922	Year 1921
Sales or Earnings (Net)			
Less			
Cost of Goods Sold			
Depreciation			
Other Deductions			
Total Deductions			
Net Manufacturing or Trading Income			
Less			
Selling Expense			
Administration Expense			
Other Expenses			
Total			
Net Operating Income			
Other Income			
Net Before Interest			
Less			
Interest on Funded Debt			
Interest on Floating Debt			
Other Charges			
Total			
Net Income Before Taxes			
Federal Taxes			
Net Income Before Dividends			
Less			
Dividends on Preferred Stock			
Dividends on Common Stock			
Other Withdrawals			
Total			
Balance to Surplus			

PROFIT AND LOSS OR SURPLUS ACCOUNT

	Year 1923	Year 1922	Year 1921
Credits			
Balance at beginning of year			
Earnings for year			
Other Credits not applicable to operations for year			
Bad Debts Recovered			
Total Credits			
Debits			
Bad Debts charged off			
Other Losses or Adjustments			
Total Debits			
Surplus as per Balance Sheet			

10. Statement of amount of depreciation charged off and manner of computing it.

11. Explanation of any unusual condition in connection with the earnings. If they are more or less than normal, it is desirable to state reason; and if earnings are low to state what steps, if any, are being taken to rectify the trouble.

12. A certification of the figures by independent auditors. (This is generally preferred by banks.)

The liquid condition of the business will be determined from the *Balance Sheet* and the *going concern* value studied from the *Income Account,* which figures should show a steady earning power proportionate to the capital invested.

Other Data Required by Bank.—Aside from the figures, a bank should receive data indicating whether

the business is a proprietorship, partnership, or corporation. The bank must also be able to form an estimate as to whether the men in charge are qualified for their positions from the standpoint of character, ability, and business record; and, if the business is a proprietorship or partnership, the bank should know their personal financial status outside of the business. The kind of business also is a factor in determining the kind of loan, maturity date, possible endorsements, etc. The geographical location of a business is another factor to be considered, as climatic, economic, political, and financial conditions in various sections of the country differ widely, and any of these conditions may have an important bearing on the soundness of the loan. The selling terms and the regularity with which business statements are issued are also important items to any bank which is considering making a loan.

Bank's Method of Studying Credit Information.—It may be helpful in the preparation of the data outlined in the preceding section, if this subject is followed a little further and a description given of the manner in which a bank utilizes the information.

The segregation of the Balance Sheet into quick and slow assets and liabilities is the first step in determining liquid condition. The next step is a comparison with similar figures for preceding years to see whether the latest figures show an improvement or a less favorable condition.

Another important test to bring out any unusual conditions is made through the method of ratio comparisons.

Relationship between items or groups of items when shown by ratios, and compared with average ratios for similar businesses, discloses rapidly and conclusively facts which would otherwise be difficult to detect. Of course, a fixed set of ratios cannot be used in all lines of business, but where there is variation from the general average it indicates that there is some unusual factor or condition to be investigated and studied to determine whether an exception should be made in the case under review.

Determination of Financial Ratios.—To attempt to express the various ratios in figures might be misleading, as some banks work on higher ratios than others, but the manner of computing certain ratios by some credit men is as follows:

Ratios to be Determined	How Determined
Cash Position	Current Assets (minus Inventory) divided by Current Liabilities
Quick Position	Current Assets (including Inventory) divided by Current Liabilities
Inventory Position	Inventory divided by Current Assets
Turnover of Capital	Net Sales divided by Capital, Surplus and Funded Debt, at beginning of year
Net Profit on Sales	Net Income before Dividends divided by Net Sales
Utilization of Plant	Cost of Product divided by Plant and Building Account
Utilization of Net Worth	Net Sales divided by amount of Net Worth
Fixed Interest Charges	Net Income before Interest on Funded Debt divided by Interest on Funded Debt
Debt Position	Total Liabilities except Capital and Surplus divided by Capital Surplus

Fixed Assets Position	Plant and Permanent Investments divided by Capital and Surplus
Trend of Collections	Receivables divided by Net Sales
Reserve Position	Reserves divided by Total Assets
Contingent Position	Contingent Liabilities divided by Capital and Surplus
Surplus Strength	Total Tangible Assets divided by Surplus Account

Quick Condition.—It is, however, a general practice among banks (dependent to a certain extent on the kind of business) to set as general standards that:

Cash should be at least 12% of the amount of the current liabilities;

Cash and Receivables should at least equal the total current liabilities;

Current assets should be at least double the amount of current liabilities;

Inventories should be about 50%, and never exceed 60% of current assets

More concretely expressed this may be indicated as follows:

		Per Cent of Current Assets
Cash	$ 4,800	6%
Receivables	35,200	44%
Inventory	40,000	50%
Total current assets	$80,000	100%
Current liabilities	40,000	
Per cent of current assets to current liabilities		200%

Further Comparisons.—It is further held generally that:

Accounts receivable should always represent merchandise transactions and that notes receivable (excluding trade

acceptances) should be small in proportion to the accounts receivable, particularly in a business where there is a rapid turnover of merchandise;

Notes payable should never exceed the Net Worth;

Notes payable for merchandise (other than trade acceptances) should be small, as otherwise it indicates failure to take advantage of discounts;

Unsecured notes payable to banks or sold through brokers should not exceed one-third of the Net Worth. (Net Worth is the amount of capital and surplus after deducting goodwill, trade-marks, patterns, etc., except the amount of their known realizable cash value);

Annual sales should equal and in general be greater than the amount of capital;

Net income before interest should be double the interest on funded debt.

While a bank may have definite standards for the purpose of disclosing weak spots in a business, that does not necessarily mean that it will not make a loan under less satisfactory conditions, if there is confidence in the men running the business or if other conditions indicate that the business is improving its financial position.

Lines of Business Where Ratios Are Different.—There are many lines of business in which the ratios stated in the foregoing discussion are not applicable, as that of the farmer, the broker, certain classes of export business, cattle loan companies, etc. When engaged in other than a purely commercial or manufacturing business, a business man should consult his bank to ascertain what it considers conservative ratios for his particular line of business, and should then govern himself accordingly.

Young Man Starting in Business.—A young man contemplating starting in business for himself might become discouraged in reading the foregoing information regarding the way bankers view an application for a loan, but he should not be discouraged if he has character, ability, and experience in the business he is about to undertake, as most bankers will be willing to help give him a start if they have confidence in him. The main thing is to make his position clear to his bank and see how far it is willing to help him, and then for him to live up strictly to the letter and to the spirit of any arrangement it may make with him.

Therefore, instead of being discouraged over the standard requirements a bank has for loaning money, the young man starting in business should study those requirements, so that he may make his business meet the standards as rapidly as possible, with due appreciation for the bank's making an exception in his case.

In the young men of today are the big business men of the future.

Plant Depreciation.—One of the most troublesome and least understood problems of business or industry comes under the general term "Depreciation."

A plant is erected; time goes on and the real estate increases in value, cost of building is higher, machinery costs much more, and the plant cannot be reproduced for double its original cost. The owner of the plant says, "Why talk to me about depreciation? My plant is worth double what it cost." True, it might be worth double its cost, if he should sell it, but he cannot sell it and con-

tinue his business. Of course, he might sell and move to some cheaper location, but it will also cost him more to build anew and to install his equipment. These higher costs, together with the cost of moving, plus loss in output during the moving, would probably not nearly compensate for the added value in the real estate and buildings of the old plant which he sold.

In saying his plant is worth double its cost, he is also probably figuring what it would cost to duplicate his machinery, but it might be that only part of the machinery could be used in some other line of business. Furthermore, all his machinery would be second-hand and probably much of it would show wear. It might, certainly, cost double the original amount to reproduce his plant, but that does not mean that it would be worth double the original cost.

Machinery wears out and becomes obsolete and there is no telling when some new method or process will be developed that may make some machine of little or no further use. Furthermore no matter how well repairs are kept up, there comes a time when general wear and tear makes a machine unfit for accurate work and it must be discarded, and the business which has made no provision for depreciation or replacement reserves, may then find that a large sum must be expended all at one time.

If the business is directed by a man who has a tendency to deceive himself over depreciation, and his foreman tells him that if he wants to get the product out in a reasonable time it will be necessary to purchase one or more new machines, because the old machines are wearing out and are not turning out as much as when new, irrespective

of time lost in repairs, he will probably add the cost of the new machines to the Cost of Plant account on the mistaken notion that he is increasing his plant capacity by the amount of capacity of the new machines, while as a matter of fact he is only increasing his original plant capacity by the present capacity of the old machines (if he still continues to use them) because of their loss of capacity through deterioration.

Replacements at Higher Costs.—If a business man desires to make proper provision for the future, there is another factor which should be looked out for in these days of increasing costs, and that is that replacement reserves should be based on the *replacement* cost of the machines instead of the *original* cost. Consequently, the man who is deceiving himself that his plant is worth double its cost and that he needs no reserves, is liable to have a double awakening when he finds not only that he must replace machinery—even if he thinks his plant is worth double its cost—but also that he must pay double for the new machinery.

Probably one reason why the importance of depreciation is not better understood is because all of the machinery does not usually wear out at one time; this may be due to the fact that machinery is ordinarily purchased at different times and because some machinery lasts longer than other machinery. Sometimes, too, a business grows and no thought is given as to whether new machinery, which may have been purchased from time to time, was for replacement or extension of plant, or both.

Business Man's View of Depreciation.—The foregoing criticisms are made specifically from the business man's point of view, as a bank can always insist on an independent appraisal from such a point of view as a condition for lending money and can thereby determine the real facts. Therefore, let us continue to look at this matter from the business man's viewpoint and ask the man who thinks he has no depreciation—because prices have gone up—what he hopes to gain by deceiving himself. If he thinks he has no depreciation, let him have an inventory made of his plant account and have it honestly valued. Let this inventory show the original cost of the machines, their probable life for turning out good work, how much of that life is passed, and how much is in the future. Then let him place opposite each a figure showing what a machine could be sold for today, another figure representing today's replacement cost, and still another figure showing an estimate of what the cost may be when the time for replacement comes due, and he will have a fairly good picture of where he really stands. Today's price will give what the machinery is actually worth if the business were to be liquidated today; today's replacement cost, what it would cost to replace the machinery today; and the third figure what it will probably cost to replace it when worn out. The latter figure should ordinarily be higher than the others, because, while prices fluctuate, the general tendency is constantly toward higher price levels.

Obsolete and Old Machinery.—In addition to the problem of depreciation for wear and tear, there is also

the question of obsolete machinery. A new machine comes along which gives greater output or can be operated at less expense than the old one and it is substituted for it. As it is naturally difficult to tell when this will happen, the most practical way of covering it is to figure a reduced life for all machinery when computing depreciation, and in this way accumulate a reserve for obsolete machinery. After this picture has been completed, let the man study it well and see where he is going to get the money to make the replacements and how little real financial significance there is in his belief that his land and buildings are "worth double their cost."

A word here about old machinery. It does not pay to use worn out machinery, as it is expensive to operate; does not produce accurate work; and, in time, the output is inferior to standard, with resultant loss in trade and good-will.

The Reserve Account.—The safe business man will make liberal reserves for depreciation and replacements. Sometimes these reserves are shown separately on the Balance Sheet, and in other cases they are deducted from the book value of the Plant Account before it is entered on the Balance Sheet.

The reserve account is created by charging the operations each year with an amount estimated to represent depreciation and obsolescence taking place during the year; if proper reserves are set up, the cost of replacements should be charged against the reserve account. These amounts reserved from profits should be represented by special cash or by investments readily convertible into

cash so that the money will be immediately available when replacements need to be purchased.

If a plant is working overtime, depreciation is naturally greater than when it is working at normal capacity, not only because of the greater number of hours the machines are running but also because upkeep is liable to be neglected at such times—all of which should be taken into consideration in computing the depreciation taking place during a year.

Other Depreciation.—Depreciation, as discussed in the preceding paragraph, relates to plant machinery, but there are many other kinds of depreciation, such as that on leases, patents, buildings, trucks, horses, farming machinery, railroad tracks and equipment, in fact on everything used in transacting business or gaining a livelihood. However, one class deserves special mention here and that is the depreciation of inventories, whether relating to material in a manufacturing plant or finished goods in a store.

As has been said before, inventories should be valued at cost or market value, whichever is lower. When market value is taken, it should be the real market value, not what the goods may have sold for in the past but what those particular goods can really be sold for currently. If this value is not to be accurately determined, it should be put low enough so that there will be no doubt of the realization value. It is better to take a loss at the time and know the worst, than to be deceived by carrying along old stock in the hope that it may possibly be worked off at some higher value. The fact that a low value is placed on the

inventory does not mean that the money will be lost if the article can be sold for a higher price. Carefully figured depreciation or marking down of the inventory will show up old stock which will go out of style or deteriorate in value if not promptly disposed of, with increasing loss the longer it is kept. Briefly, reckoning depreciation accurately keeps a business man from getting a wrong picture of his financial condition, and shows him exactly where he stands, from a business point of view.

Jigs, dies, patterns, etc., are just as essential to many manufacturing concerns as buildings and machinery, but they may be of no use for any other business and, if they have no realization value, they should be charged off over a reasonable period.

Good-will is a very elusive element. In many cases it has a distinct money value and in other instances it has no value at all. When value exists, it has a proper place among the assets; but when it has no value it should not appear on the Balance Sheet.

CHAPTER VII

FOREIGN COMMERCIAL CREDITS AND PROTECTION AGAINST EXCHANGE RISKS

Difference between Foreign and Domestic Credit Requirements.—The handling of credits in connection with foreign transactions (import and export of commodities) differs from the handling of domestic loan credits granted in the United States, in that foreign credits are —in the larger number of cases—secured by the direct pledging of commodities. Thus, except when clean lines are granted, the chief concern of the lending bank is first to assure itself that the customer's business methods are sound and his integrity is highly rated, and second, that he is good for the difference between the amount advanced by the bank and all possible depreciation in the value of the commodity for which the advance is made until the amount is repaid. If the transactions are in the nature of commercial letters of credit for export or import of goods, the bank charges a commission for its services in granting the credit; consequently the requirements for average balances, etc., are usually less than for the usual domestic loans and also because on domestic loans the bank is advancing money, while on commercial letters of credit it is chiefly lending its credit. The amount of work and expense in issuing a letter of credit is, however, much greater

than in making a domestic loan. This expense the bank must make up out of its commission.

In the great bulk of exports from this country, consisting of cotton, grain, copper, etc., the principals (that is, the producer and the consumer) are not even customers of the bank, and in most instances are ignorant of the name of the bank handling the transactions which are of such vital importance to them. This fact can be illustrated by considering a shipment of cotton from the United States to England. A cotton spinner in England, desiring to buy cotton in the United States, first goes to a local cotton broker or import merchant in Liverpool and informs him of his special requirements. This broker gets in touch by cable with exporters in the United States, secures a firm offer (generally expressed in pounds sterling), and submits it to the manufacturer. If they agree, the purchase is confirmed and the British manufacturer then goes to his bank in Liverpool or London and establishes a credit for such amount as he estimates will be sufficient to cover the purchase. As a rule the reimbursement is 60 days' sight drafts on English banks, such drafts being drawn in pounds sterling.

Conversion into United States Currency.—The exporter or shipper of cotton in the United States must secure United States currency for the shipment, so that he can settle with the cotton grower who, naturally, could not use the English currency. The exporter therefore sells the 60-day or 90-day English drafts drawn on the English bank designated by the manufacturer, to some bank in New York, Chicago, New Orleans, Boston, or

Philadelphia; or he may sell to a local bank which will sell to some bank in one of the larger cities.

So far the method used is comparatively simple, but the negotiation by a bank of drafts covering an export transaction requires expert knowledge, foresight, and sound judgment. These drafts carry no interest, and the period for which they are drawn only begins at the time of acceptance. They are also susceptible to other charges abroad. It will therefore be apparent that when the American bank makes a quotation in dollars for the draft in question, this quotation must cover interest from the date when the shipper is paid for the draft until it arrives abroad, also interest for the period of the tenor of the draft, stamp charges, and possible bank commissions.

Risk of Exchange Loss Minimized.—The risk of exchange loss to the American bank on transactions of this kind is usually minimized by the following method. The bank simultaneously covers its exchange position through selling forward exchange for delivery at the anticipated date on which a given draft will be due. Consequently, the current market price for forward exchange becomes a determining factor in fixing the price at which the American bank purchases a draft. It is not meant by the above that the American bank actually keeps separate and distinct each transaction of this nature until its ultimate conclusion. The draft in a transaction of this kind is probably rediscounted in England shortly after its arrival there. If each transaction were treated separately and every 60-day draft rediscounted upon arrival, the bank would naturally have on hand the amount of sterling

stated in the draft, which would not be deliverable under a specific forward sale contract for perhaps some 60 days. What really happens is that the officer in charge of the foreign exchange trading of an American bank is continually buying and selling exchange and governs his transactions by his total current position in any given currency. Therefore, when he has had drafts rediscounted upon arrival in London, he immediately effects some other trades to offset that particular transaction and also provide for the outstanding forward sale contract.

The grower of the cotton does not know or care anything about this intricate figuring or transaction in exchange; he simply sells his cotton at so much per pound. But the figuring and trading must be gone through with, and the machinery must be ready to do it or the cotton grower cannot get his money without great delay.

Credit Standing of Parties.—Computing a fair price to pay for the sterling draft is not the only difficulty in this transaction, however. These drafts are drawn by a great many people on a great many banks and other names, and the American bank purchasing them is obliged to know the credit standing of the drawer, the drawee, and of any other party appearing on the draft. The American bank must also watch to see that it does not have in its portfolios too large an amount of drafts on any one foreign bank at one time. As a rule the American bank will rediscount these drafts in the London market as rapidly as possible, as even the largest American banks have not sufficient resources to hold all the drafts until maturity. In turning over these drafts rapidly in this

way, the American banks are in a position to handle a much greater volume of such drafts, thereby facilitating the movement of the crops.

These drafts are secured by the commodities for which they have been drawn, and in some instances they are further secured by the deposit of margin with the American bank handling them, although in the majority of cases they are purchased as straight documentary paper.

It is obvious that, in judging credit for this line of business, the ratios for fixing commercial lines of credit do not apply, as the exporter drawing the draft is not—like a merchant—engaged in manufacturing or carrying a stock of goods, but is rapidly turning his capital over in buying and selling raw commodities and the smaller amount of capital he requires is entirely out of proportion to the amount required for the same volume of transactions by a manufacturer or merchant. The credit of the accepting English bank would be viewed from a banking standpoint and the reputation of the bank and its conservatism in the granting of acceptances. When the credit of the English manufacturer is an issue, it naturally is viewed from the same standpoint as the credit of manufacturers in the United States.

Future Exchange Helpful in Eliminating Speculation.—The buying and selling of forward exchange, generally referred to as the "future" market, is extremely helpful in eliminating speculation, although unfortunately the process is not generally understood and there are doubtless many business men having business transactions

in foreign countries who fail to protect themselves by this thoroughly wise and legitimate process.

It has been shown above how banks protect themselves and eliminate speculation in moving the crops exported from this country. This is made possible because someone in the United States or South America or some other country has a commitment to pay a certain amount of sterling in England on a certain day, perhaps 60 or 90 days ahead, and desires to purchase the exchange at the prevailing rate, in order to eliminate speculation as to what the rate of exchange may be at such later date. Such person therefore enters into an arrangement with his bank to purchase a forward contract of exchange to be delivered on a certain date. This may be with a bank dealing in foreign exchange or through a local bank which will pass the contract on to some other bank until it finally reaches an institution which trades in foreign exchange. The multiplicity of these contracts, both for the purchase and sale of all kinds of foreign currencies, both demand and future, makes the markets in the larger financial centers, and also makes it always possible for the business men of the United States who are dealing with foreign countries to protect their exchange position and not run the risk of large losses due to increases or decreases in exchange rates, pending the completion of a business transaction.

Covering Exchange Position When Exporting.—One of the amazing conditions in American business brought to light after the war, through the heavy decline in the values of foreign moneys, was the number of concerns selling goods in foreign countries which had not

made a practice of properly covering themselves in the matter of exchange, and which sustained severe losses through exchange depreciation when the time came for them to collect their money. In some instances concerns are still carrying in foreign countries money representing the proceeds of sales made months or even years ago, in the hope that exchange rates will eventually return to normal and that their money can then be converted into dollars without loss.

If a business concern wishes to avoid speculation in exchange it should, when selling goods to a foreign country (if the goods are to be paid for in foreign currency) sell simultaneously an amount of foreign currency of that country equal to the amount that it will receive for the goods sold.

To illustrate, suppose that an exporter in the United States desires to sell a machine in France, the price of which is $800, and that the purchaser wishes to pay for it in francs. The exporter, in order to find out how many francs he should charge, would ascertain the exchange rate for francs at that time, and if it were found to be, say, 8 cents per franc, he would bill the machine at francs 10,000. If payment were to be made the same day, all would be well; but let us suppose that payment is not to be made until the arrival, or possibly three months after the arrival, of the goods. Then the proceeds of the sale, in francs, would be realized only at the rate of exchange of the day that payment was made in francs, and if francs happened to have declined in the meantime to, say, 6½ cents, then the exporter would receive only $650 instead of $800.

One way of eliminating the possibility of a loss of this kind is to arrange, under the terms of sale, that the exporter shall draw a draft on the purchaser at, say, three months' sight, for francs 10,000, and then immediately sell the draft to a bank dealing in foreign exchange. The exporter receives payment immediately and is through with the whole transaction, unless the draft is not paid at maturity, in which event he is obliged to refund the amount to the bank. Of course, the bank in purchasing the draft deducts from the proceeds an amount to represent interest for the use of the money until the draft is collected. On the other hand, the exporter has the use of the money in his business during such time.

If the method described above is not possible, or desirable, another means of protection may be used. In this case, the exporter, at the time of the sale of the machine, enters into an arrangement with a bank dealing in foreign exchange, by which he agrees to deliver to the bank francs 10,000 at 8 cents on an agreed future date, say, three months hence, if that is the time that payment on the machine is due. Then it only remains for the exporter to collect the francs, deliver them to the bank upon the agreed date, and receive $800.

Purchasing Bank Protected.—It may seem that, as the exporter is thus relieved of the risk of decline in exchange, the bank is assuming the risk, but this is not the case, as the bank resells the francs immediately to some importer who needs francs to pay at a future date, for the purchase of goods in France, so that the

circle is complete without risk to any of the parties concerned.

In banking circles this is known as dealing in forward contracts of exchange, as previously explained. The bank naturally expects to make a reasonable profit out of such transactions by selling the francs at a higher rate than it pays for them. In other words, it is dealing in exchange, buying and selling foreign currencies, just as a store buys and sells commodities. In doing so it performs one of the very useful and necessary transactions by which international business is carried on.

Covering Exchange Position When Importing.— On the other hand, when a concern in the United States is a purchaser of goods in a foreign country, which are to be paid for in a foreign currency, it should protect itself in the same way by making arrangements to obtain simultaneously the necessary foreign currency. This it can do by purchasing the foreign currency and carrying it in a checking account, or the firm can enter into an arrangement with a bank for a forward contract of exchange available when payment is due.

If a concern is doing much foreign purchasing it may find it convenient to open regular checking accounts in foreign currencies in the various countries, carrying such accounts either in native banks or in foreign branches of American banks. The mere fact that a concern has such an account, does not necessarily mean, however, that it is properly covered on its exchange position. This is simply a method of operation, and whether or not the exchange position is covered depends on the balance in

the account, the rate at which it was purchased, and the amount of money required for the given transaction.

The purpose of this and the preceding discussion is to impress upon the business man the importance of always covering his exchange position when he is buying or selling in a foreign country, if the transaction is to be settled in a foreign currency.

Illustration of Loss from Exchange.—An example of the danger of not doing this can be seen from the following actual instance of a failure to take this precaution.

An American entered into an arrangement with a native of Czecho-Slovakia, whereby the American was to purchase and pay for raw cotton to be shipped to that country, and manufactured into finished goods there, the Czecho-Slovak to advance the costs of manufacture. The finished goods were to be sold in the United States, and each party was to receive a proportion of the profits after allowing for all costs. The venture turned out well from a commercial point of view, but no provision had been made for the exchange element in the transaction. When the American came to remit part of the proceeds to the Czecho-Slovak, to reimburse him for his manufacturing costs and to pay his share of the profits, he found that Czecho-Slovak exchange had gone up to such an extent that it more than wiped out his (the American's) share of the profits. He sustained an actual loss on the transaction, whereas he could have had a substantial profit if he had covered his exchange position properly.

The moral of this is that any business man contem-

plating a transaction with a foreign country would do well to discuss the matter with his bank before making arrangements or commitments of any kind, unless he is himself thoroughly familiar with foreign transactions and knows how to cover his exchange position.

The Credit Factor in "Future" Exchange Contracts.—The question of credit facilities also enters into the making of forward exchange contracts, because the bank must be sure that the person with whom the contract is made will be able to take up the purchase, or will be able to deliver the foreign currency sold, on the date agreed, irrespective of what the exchange rate may be at such time. If the customer is not able to perform his contract, the bank must go into the market and either buy or sell the exchange, as the case may be, at the prevailing rate. If there has been much fluctuation from the contract rate, a considerable loss may arise in covering the transaction. Therefore the bank must be reasonably sure that the customer will live up to his contract or is good for a possible loss.

CHAPTER VIII

FOREIGN SERVICES RENDERED BY BANKS

Using Local Banks for Foreign Exchange Transactions.—A man may find that his bank has no foreign exchange department. But this is not especially material, as without question his bank has correspondents or has connections with other institutions which do deal in foreign exchange, and it can, therefore, deal with such banks for him. For instance, a man in a small town in the Middle West might desire to cover an exchange position by a forward contract for exchange. He might be totally unknown to a foreign exchange bank in New York or Chicago which would hesitate to enter into the arrangement with him personally without investigating his credit, because the bank might sustain loss if he did not complete his contract by delivering or receiving the foreign currency on the date agreed. On the other hand, the foreign exchange bank would be quite willing to enter into the transaction through his local bank, which knows his credit standing.

To cite another case, a man may intend taking a trip abroad later in the year, and seeing that exchange rates are low, he may desire to take advantage of them by purchasing his foreign currency immediately. This his local bank can also arrange for him through its correspondents, either by a Traveler's Letter of Credit in foreign currency, by a deposit account in a foreign branch

of an American bank (which would probably allow him interest on the deposit), or by a foreign currency account in a bank in the United States.

In fact, it is possible for his local bank to transact all kinds of foreign exchange business for him, and if it is not thoroughly familiar with all aspects of a given transaction, it can secure the information by a plain presentation of the case to the correspondent bank which has a foreign exchange department and in whose hands the business is to be placed.

Collection of Foreign Currency Bills.—The foreign exchange business is highly specialized, and to attempt to enter into technical details would not only complicate this discussion, but might be misleading respecting some particular transactions. Thus the information given here will be confined to the services a bank has to offer, and will leave it to the individual business man to put his particular case before his bank in order to determine the method which best suits his needs.

Foreign collection service covers all kinds of drafts drawn on foreign countries. The drafts may be in dollars, but usually are in foreign currency. In the latter case, unless they are immediately sold to the bank at the current rate of exchange, the person who presents the drafts for collection should cover his exchange position by selling a forward contract of exchange for the amount of the drafts. In many instances banks are willing to lend money on items, both foreign and domestic, placed with them for collection, thereby making the proceeds immediately available to the customer.

Collection of Foreign Securities and Coupons.—Unless these items are sold when delivered to a bank, the exchange position should be covered as in other foreign exchange transactions.

Import Letters of Credit.—Import letters of credit are in frequent use when an individual or business house in the United States desires to import goods. Suppose it is silk that is to be imported from Japan. The credit standing of the American concern may not be known in Japan; so the American concern goes to its bank and asks for an import letter of credit sufficient to cover its requirements. The American bank, either directly or through a bank engaged in foreign exchange business, issues an import letter of credit to the house in Japan which is selling the goods, or to its bank in that country, authorizing the drawing of drafts on the American bank to pay for the goods, under conditions which are fully set forth in the letter of credit. Sometimes these letters are drawn in dollars and sometimes in foreign currencies. If such a letter is drawn in a foreign currency, the importer should cover his exchange position by purchasing a forward contract of exchange so that he will know exactly what he will be obliged to pay in dollars; otherwise the exchange rates may go up before the drafts arrive and his silk cost him proportionately more. Drafts drawn under letters of credit can be drawn at sight or on time. Many importers find this method more desirable as it is usually easier for them to purchase goods on time when the credit of an American bank is back of them, as evidenced by an import letter of credit, than if they make settle-

ment direct with the seller without the assistance of such credit. If time can be secured, it may be possible to resell the goods and collect the proceeds before the draft comes due.

Export Letters of Credit.—In an export case the position which has just been outlined is reversed; the American concern is selling to a purchaser in a foreign country and wishes to protect its credit risk. It therefore directs the foreign purchaser to have his bank in his own country secure letter of credit facilities with a bank in the United States, which will honor the drafts when shipments are made. In this case, the American concern relies on the credit of the American bank, the American bank on the credit of the foreign bank, and the foreign bank on the purchaser, with whose credit standing it should be familiar. Almost without exception, export letters of credit are in dollars and thus the purchaser has the burden of covering the exchange position.

Granting of Acceptance Credits.—A description of acceptances has been given on page 16. Here, merely the use of acceptances for imports and exports will be discussed. The results accomplished by the use of this type of document are the same as with import and export letters of credit, the principal difference being in the form. For instance, when an American firm knows from whom it will purchase certain goods, say, in Japan, it will probably use the import letter of credit form, which the seller can exhibit to a third party as authority to draw drafts.

In instances when the seller ships and draws direct on the purchaser, and the latter wishes to provide himself with the means of meeting such drafts, he can adopt the acceptance method by arranging with his bank to grant him an acceptance credit "to finance the importation of merchandise," under which he can draw a draft to his own order and have it accepted and discounted by his bank, using the proceeds in payment of his purchases.

In export business the use of the acceptance is more general than the use of export letters of credit, and most of the exports of cotton, grain, beef, etc., are handled in this way. These transactions are in great volume and the credit arrangements are made in advance, so that banks in the United States constantly purchase drafts before they have actually been accepted in foreign countries. Thus the business man in the United States is able to obtain his money immediately from a given transaction. This means, however, that the bank purchasing the draft holds the drawer of the draft primarily responsible for its goodness pending its acceptance abroad. Such drafts are, however, usually further secured by the commodity for which they are issued. In some instances a deposit of cash as a margin is also required, dependent somewhat on the nature of the transaction, the kind of commodity, and also on whether the sale price is much above the normal market value. Of course when these drafts or bills are *sold* to American bankers, the drawer in America is not concerned with the exchange rate at the maturity of the draft, but if they are sent for *collection,* the American concern should cover its exchange position.

Discounting Acceptance Drafts.—To make the plan of payment by acceptance of real value there must be a market where the holder of the acceptance can dispose of it for cash. Many banks find these acceptances a desirable way of investing surplus funds by discounting them for the holders. There are also some discount companies which deal exclusively with this class of business and there will doubtless be more in the future, as this kind of business is still relatively new in the United States.

Purchase and Sale of Foreign Exchange and Currencies.—Certain banks specialize in this class of business. However, through a system of correspondents and co-relations this service is open to everyone through any local bank. The result is that a person can buy or sell foreign exchange, protect himself by forward exchange contracts for goods bought or sold in foreign countries, purchase checks or drafts drawn in foreign currency in payment for expenditures in foreign currencies or for remitting funds to people in foreign countries; in fact he can carry on all kinds of banking transactions with foreign countries.

Foreign Credit Information.—Banks doing an international business usually have considerable credit information in their files regarding banks and business houses in foreign countries which is available for the use of customers. When the information desired is not on file a bank can usually obtain it from its correspondents in foreign countries. This is a very valuable service which banks can and do render to customers. The maintenance

of this credit service means a comparatively heavy expense on the part of the bank, which customers should remember in their transactions with the bank.

Business Methods in Foreign Countries.—Before undertaking business in a foreign country the citizen of the United States should be familiar with the customs, regulations, and business methods of that country, as methods of doing business vary in different countries and in many countries are quite different from the practices in the United States.

Banks doing an international business can usually supply such information and the Department of Commerce in Washington will also supply foreign trade information upon request.

Travelers Letters of Credit.—Many banks and trust companies and some private bankers issue Letters of Credit for use of travelers, and banks which do not have their own forms usually have a supply of forms issued by banks and trust companies which are better known in foreign countries. These letters can be drawn in dollars or in certain foreign currencies. If drawn in dollars, whenever money is drawn under a letter in a foreign country, the holder is subject to the rate of exchange at the time that the dollars were converted into foreign currency. To obtain fair rates of exchange the holder should use care in selecting reliable banks in foreign countries when drawing money under dollar letters of credit. A list of reliable correspondents is usually supplied with each letter of credit. If exchange rates for foreign cur-

rencies look low at the time a letter of credit is purchased, and the purchaser desires to take advantage of such low rates, it may be desirable to purchase three letters of credit, one in pounds sterling, one in francs, and one in dollars, and use them according to fluctuations in exchange rates. Should the rates for foreign currencies advance, the sterling or franc letters could be used; while if the rates went lower than at the time the letters were purchased, the dollar letter could be used. The purchaser should of course understand, if he follows this suggestion, that he would sustain a loss if he did not use his sterling or franc letters and the exchange rates are lower when he wishes to cancel the sterling and franc letters, than they were at the time he purchased them.

Dollar letters of credit can be purchased for cash or on credit according to the customer's standing with his bank. If purchased on credit, the arrangement is to charge the customer's regular checking account with all drafts he may draw under his letter of credit. If a letter of credit is in sterling or francs, it is paid for in full at the time of issue if the purchaser desires to fix the exchange rate at that time.

Credit the Backbone of Business.—The whole structure of modern commerce is built on credit, and the banks are the agencies through which much of this credit is cleared. Germany has, doubtless, vast resources, but its credit is destroyed, and consequently it lacks the opportunity to employ its man-power and resources in making any reasonable reduction of its indebtedness. This is a

large-scale illustration of the principle that a man should be most solicitous of his credit standing if he would make the most of his opportunities. He should be frank and fair with his bank; then, if evil days come upon him, he will find his bank much more willing to help him than if he has impaired his credit by misrepresentations or by failure to live up to agreements.

Businesses are divided into more or less general groups and some groups rarely, if ever, come in contact with others. Consequently, while one group may be dependent on some other group or groups for its trade and resultant success (if not selling direct to the consumer), it may give little thought to what is taking place in other groups with which there is no direct contact. Banks, however, are necessary to all groups and come in contact with all kinds of businesses. Consequently, they are well informed on general business conditions, and this information is available to those who wish it. In brief, banks are the common meeting-point of all kinds of business. If the commercial world is to derive the greatest benefits from banking, there must be mutual confidence and the closest co-operation between business men and banks, both of which can be attained only through a thorough understanding of the banks' point of view as well as of the needs of business. Conversely, the business world is fundamentally necessary to the success of the banks, and banks should assist their customers in every way possible.

Labor Union Banks.—During the last year or two, banks have been established by Labor Unions, and in the opinion of the author, this may be one of the most helpful

events that have occurred in banking circles since the establishment of the Federal Reserve System. Labor Unions represent the working man who as a rule has but little knowledge of banking, and such data as he does get is usually greatly distorted and misunderstood. Thus the operation of banks by Labor Unions, if conducted on a sound basis, should do much to educate the working man to the real importance and functions of banks and their absolute necessity for transaction of business, which is as vital to *his* existence as to that of anyone else.

Summary of Bank Credit Requirements.—It is usually of advantage to learn the other person's point of view, and the purpose of this book is not to lay down any hard and fast rules—but to set forth the principal requirements of many banks in granting credit. These requirements, which have been discussed in detail, may be summarized as follows:

Character, integrity, and a willingness to live up to agreements under all circumstances;

Complete and accurate information, clearly presented;

Reciprocal relations in the matter of deposit balances and in the other ways in which a customer can facilitate the business of his bank.

If these requirements are met, customers will usually find bank officers glad to extend all reasonable accommodation, if they are in position to do so. Thus to the business man the bank is an outside source of credit on which—conditions being favorable—he can draw freely. Important as this is, the alert business man can reap many

other and almost equally important advantages from close contact with the officers of his bank, who can frequently give advice or information which will be vitally helpful in the transaction of business. In brief, a bank well used may often prove a real friend in time of need.

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